

# Economic Growth Officers Training Workshop

## Module 3: Banking



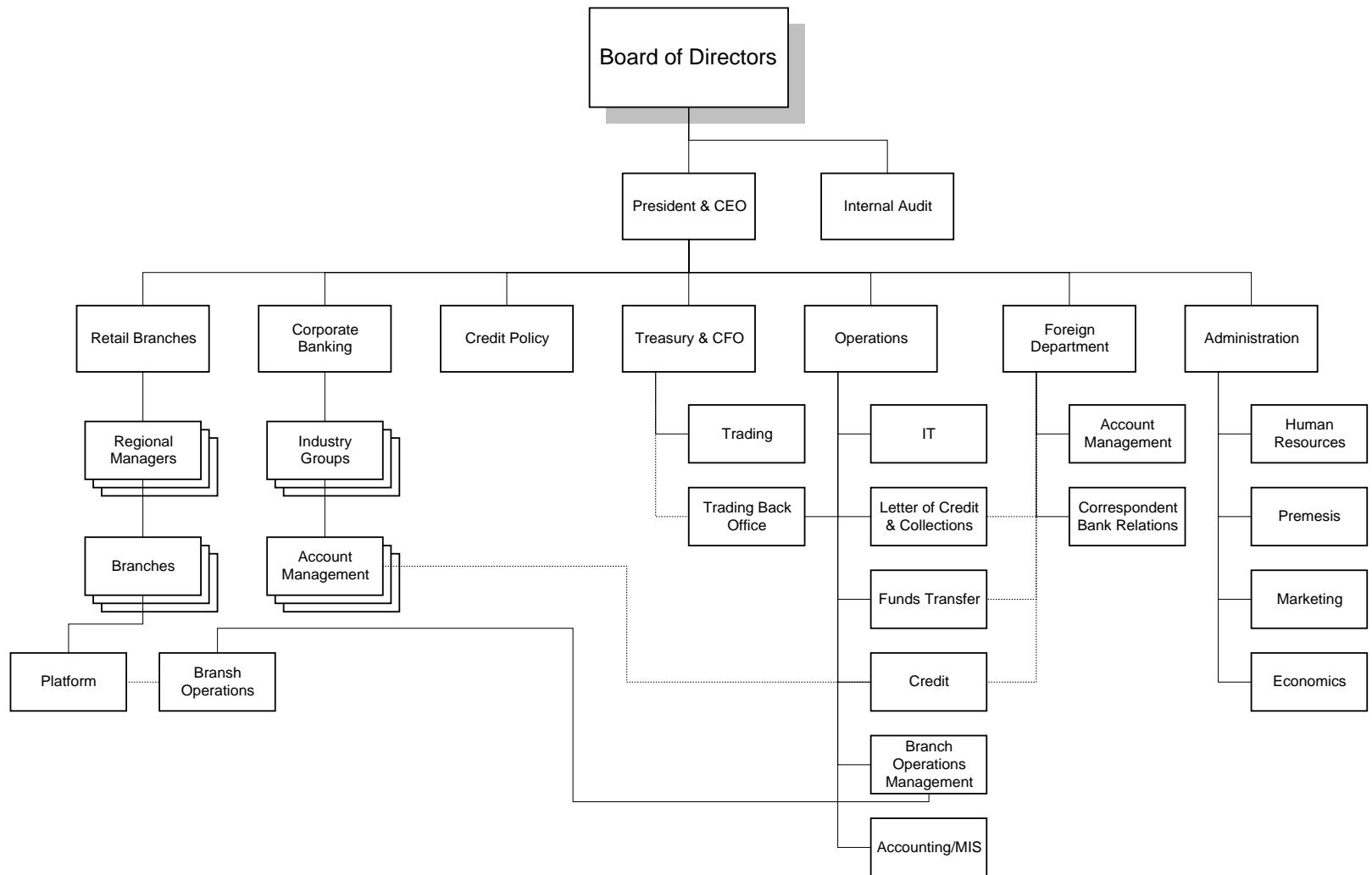
# Objective

- This presentation will start with a look at what constitutes a bank
- We will then look at market structure and how banking fits in
- At or about 10:30 we will take a break
- After the break we will look at New Products and Services
- Then we will look at foreign involvement in banking development
- Cover some basic dos and don'ts in designing SOWs
- Highlight some of the areas where USAID can focus its help
- End at around 11:45 with what EGAT can do to help you

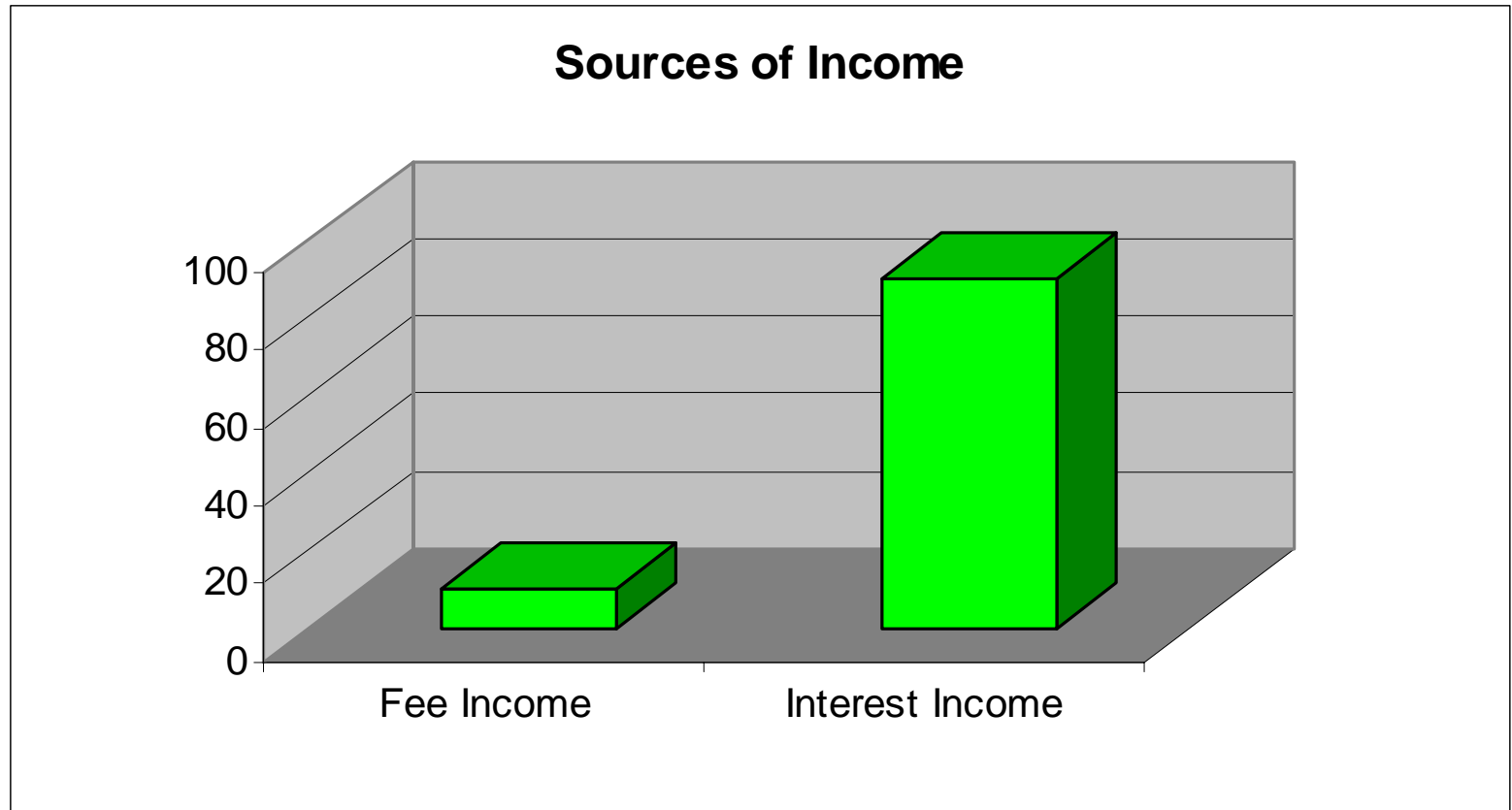
# What Constitutes a Bank?

- Institution licensed to intermediate between
  - savers with cash surpluses and
  - borrowers who can use the funds to create sufficient value to repay principal and interest plus make a profit
- Performs maturity transformation – converts short term funds to longer term funds
- Provides trade settlement services that facilitate the exchange of goods and services for cash
- Essential to economic development

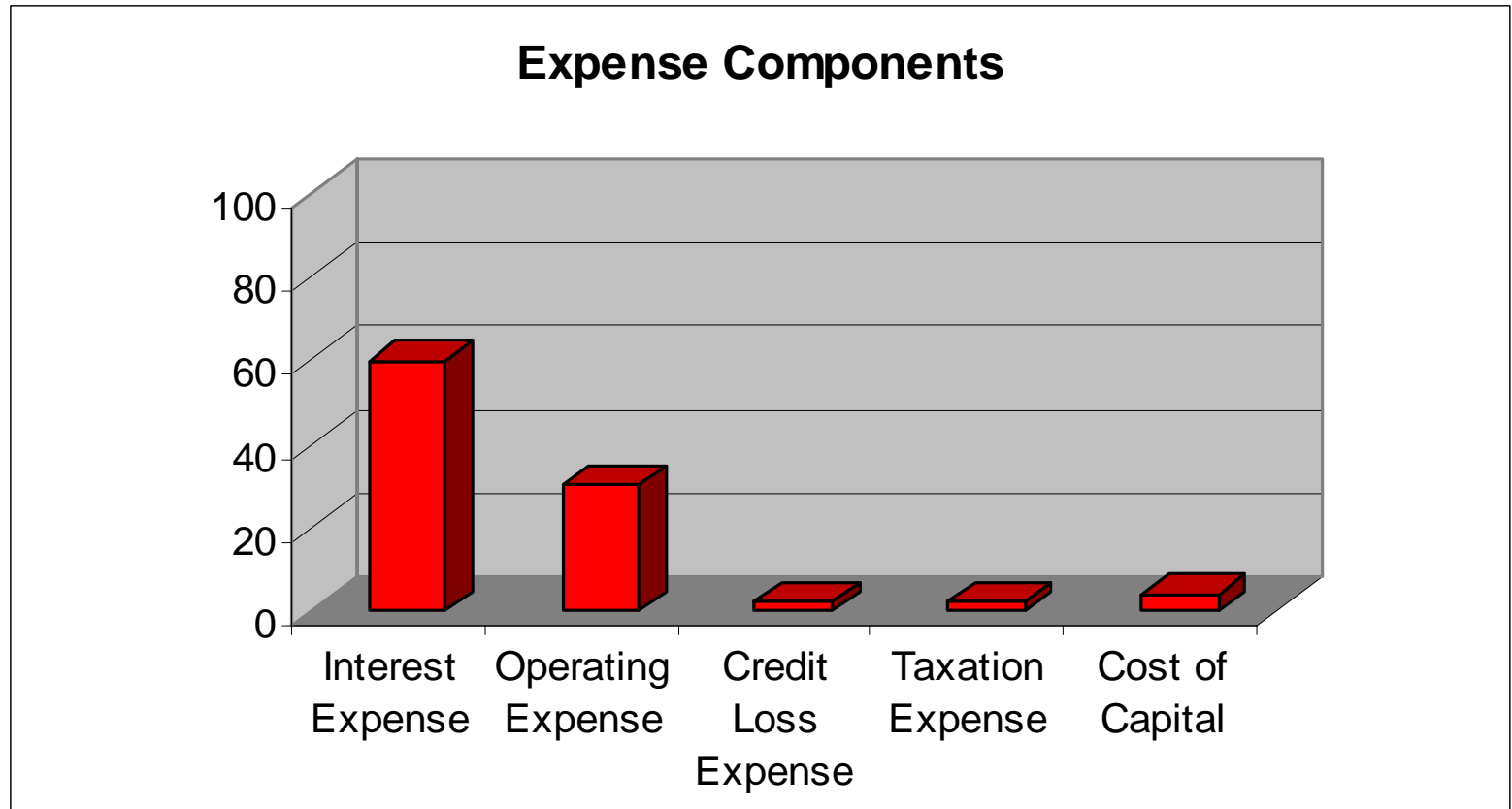
# Typical Bank Structure



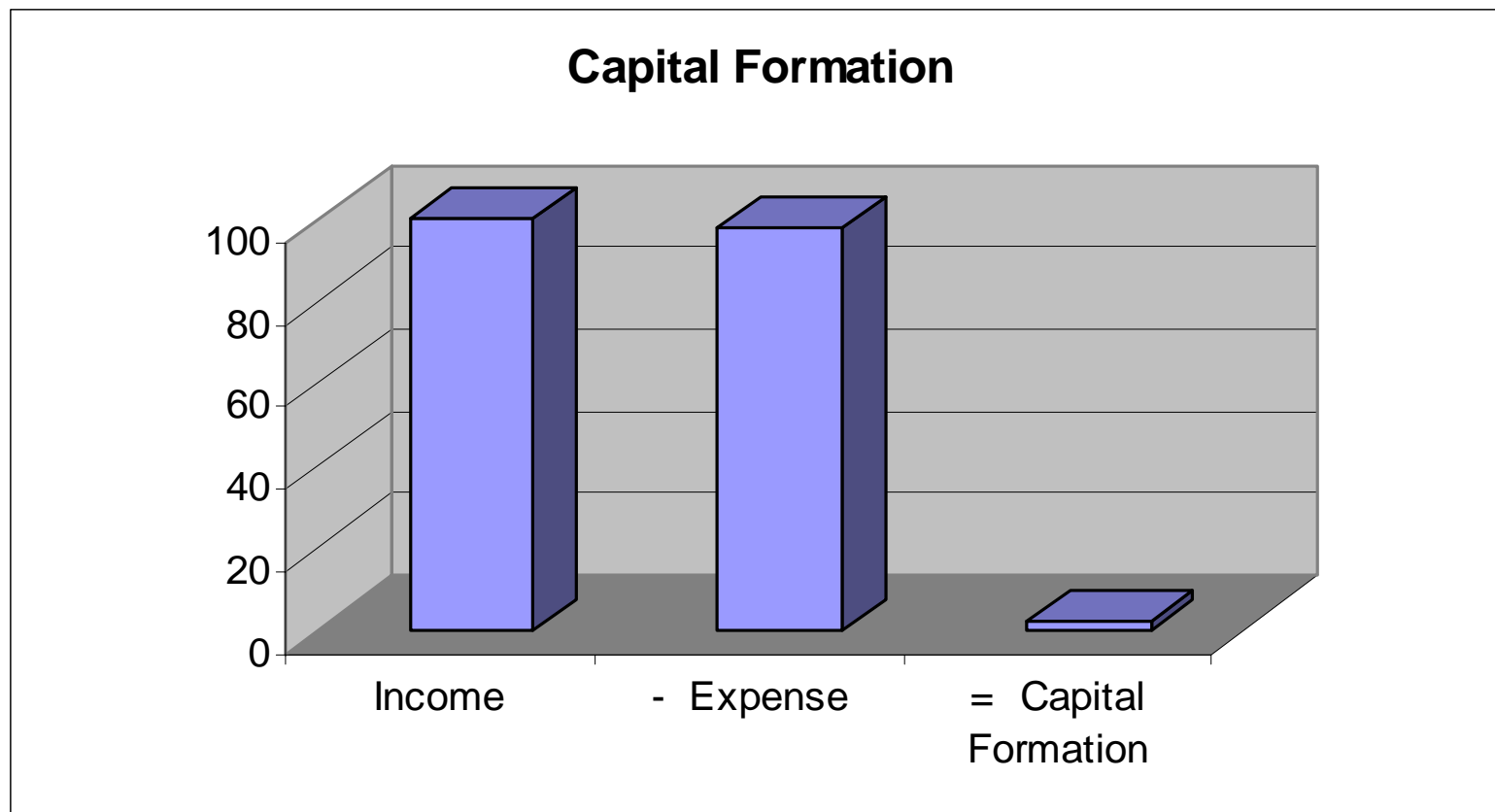
# So How does a Bank Survive?



# So How does a Bank Survive?



# So How does a Bank Survive?

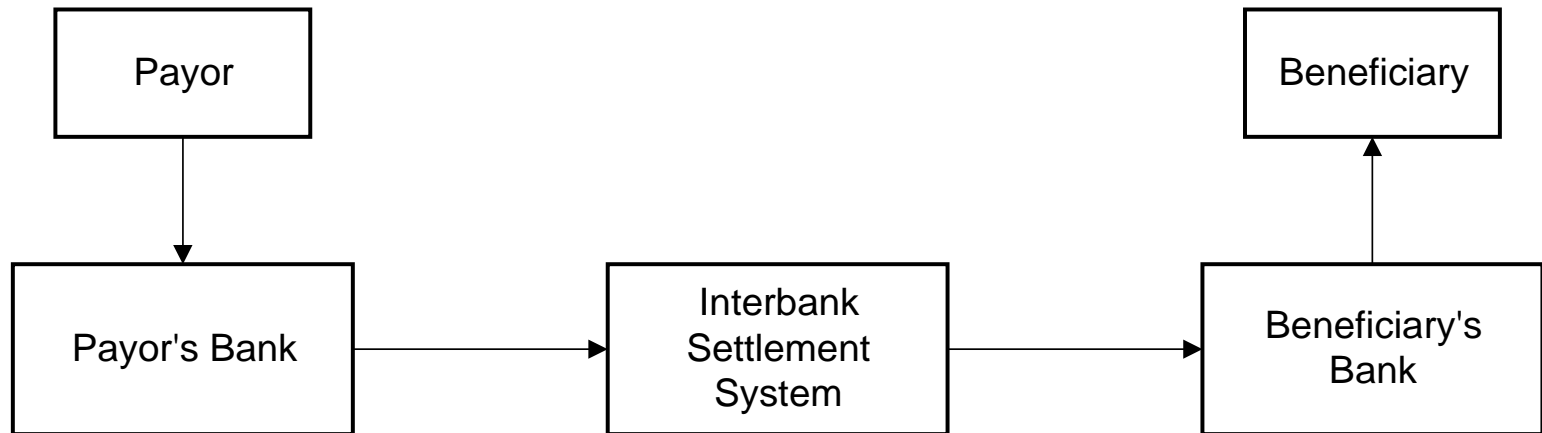


# What is “Intermediation”?

- The pooling of short term savings within the formal financial system to fund the activities of people or institutions
- Requires sourcing funds with the “most appropriate” blend of maturity and cost
- Requires lending to borrowers who can pay back as agreed based on the projected cash flow of the borrower
- Requires minimizing operating costs consistent with sound risk management

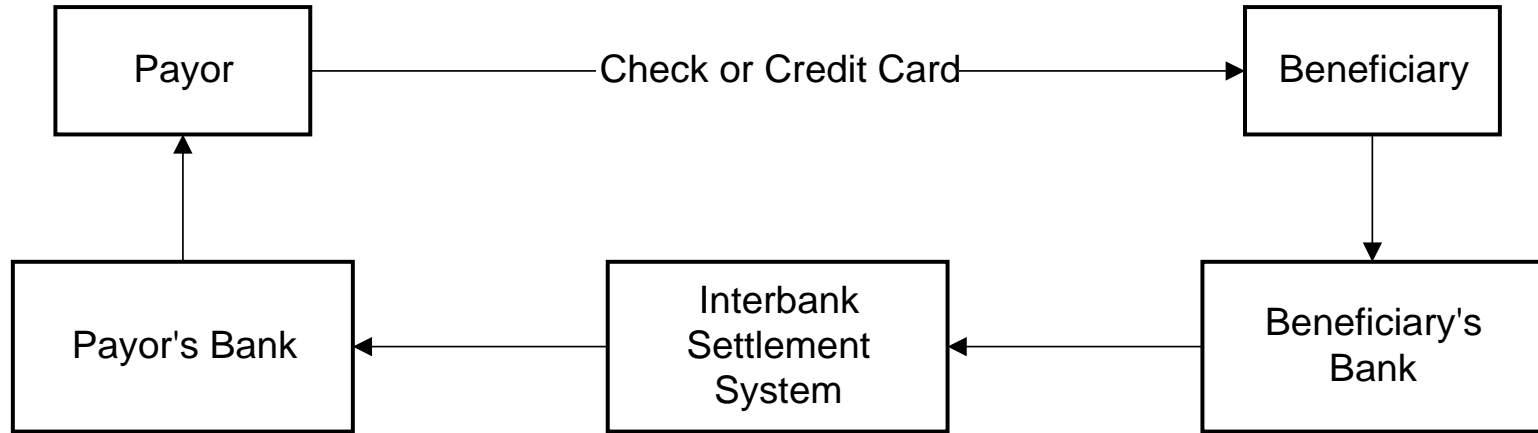


# Structure of the Payment System



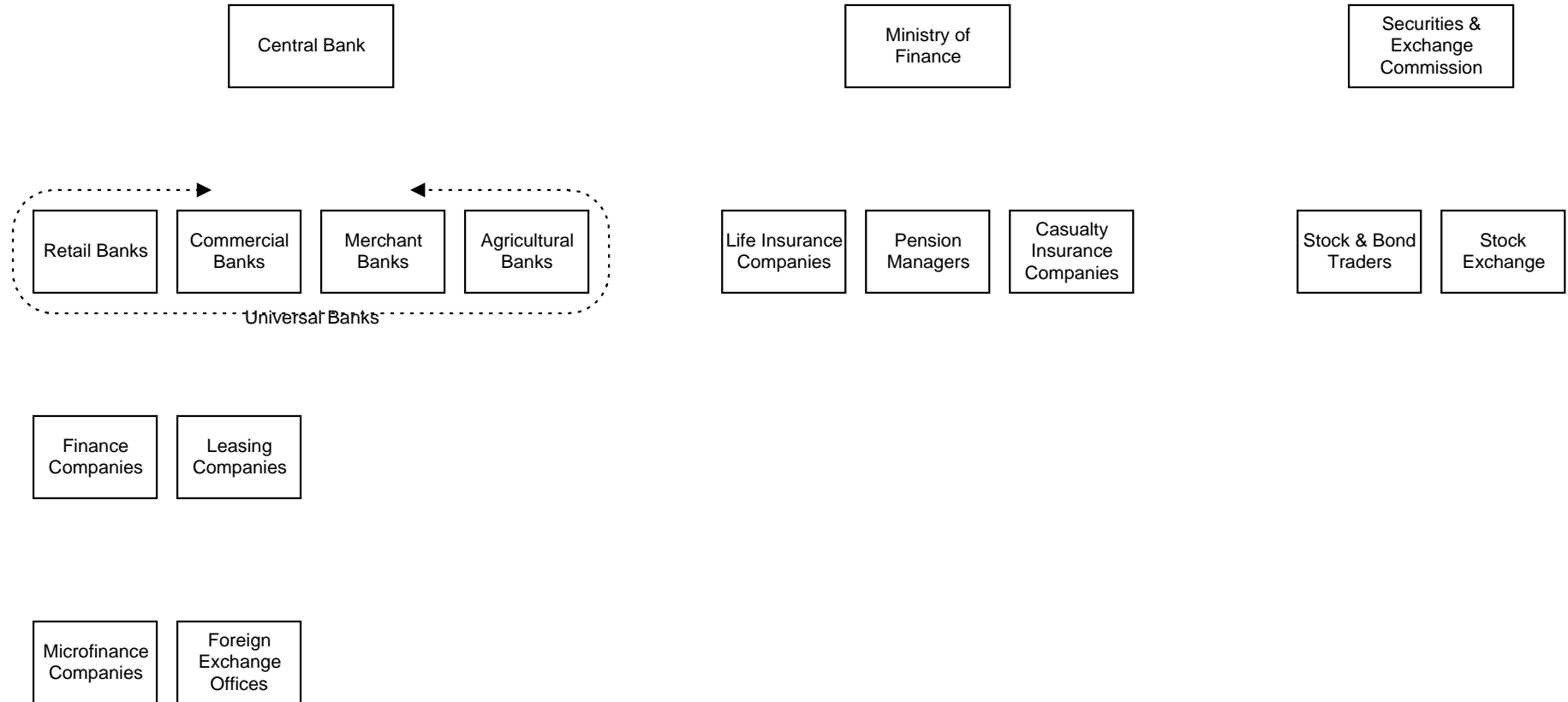
- Local Interbank Settlement – Clearing House, Central Bank, Correspondent Bank
- International – S.W.I.F.T., Western Union

# Settlement System



- Document flow is reversed
- Potential for “bounce”
- Local – Clearing House, Central Bank, Correspondent Bank
- International – “Cash Letter” service to correspondent bank or MC/Visa...

# Market Structure – Types of Banking Institutions



# Break

- See you back here in 15 minutes

# Developing New Products and Services

- This is on the agenda, but not really an issue for us
- Banking products and services in our markets will lag OECD countries
- Deepening of financial services should be limited to importing financial service products that have demonstrated success in more advanced economies and that are reasonably applicable in the local environment
- Our countries cannot afford to be guinea pigs
- Good banks will add services based on client needs, market conditions and competitive pressure, so intervention by us should not be necessary

# Developing New Products and Services

- Where we have gotten in trouble in the financial sector has been where we have pushed products or services before the market was ready for them
- Our client countries will, if anything, move too fast in adding new services
  - Mortgage banking in Kazakhstan
  - Pension systems
  - Stock exchanges
- If we help a country get the basics right, then the market will determine what new products and services are appropriate

# Foreign Involvement in Banking Development

- Strengthening supervision of banks
  - Improving the “enabling environment”
    - Legal and regulatory framework
    - Dispute resolution (court system)
    - Accounting transparency
  - Removing market spoilers
- Enhancing management practices – training, association building
- Acting as a catalyst – supporting specific institutions
  - Direct management
  - Donor credit lines

# When does a Bank Fail?

- *When it loses Public Confidence*



# Why does a Bank Fail?

- ★ Inadequate interest differential margin - inappropriate pricing
- 🕒 Loss of cost control - inefficient, services not suited to market
- 🕒 Loss of internal control - defalcations, fraud, systems failure
- 🕒 Loss of risk control - unable to recover loans
- 🕒 Inadequate liquidity - can't honor depositor withdrawals
- ➡ ***Loss of Public Confidence***

# What can USAID do?

- Everything we do with bank supervision projects focuses on managing the five causes of bank failure that we have just reviewed
- So what should our objectives be for financial sector work?

# What can USAID do?

- Build *legitimate* Public Confidence in the banking system
- Lower the systemic risk to financial intermediation
  - Banking laws and regulations - take out market spoilers
  - Contract law - enforce lending and commercial contracts
  - Bankruptcy law - resolve claims in case of failure
  - Court system - rapid, predictable settlement of disputes based on law and facts
  - Fiscal discipline - avoid crowding out
  - Accounting framework and reporting - increase transparency
- Provide exposure to market experience and best practices - training

# Avoiding Distortions

- We cannot force the pace of development
  - Well managed banks reflect what is reasonable and prudent in their environment
  - Forcing the pace of development causes bank failures
- Well intentioned programs can have serious consequences
  - Lesotho: “Improve the Level of Technology in Agriculture”
  - Uganda: rebuild cooking oil production capacity







# Target Catalyst Actions

- Strengthen the enabling Legal and Regulatory Infrastructure
- Encourage good Governance and Transparency
- Use Development Funds / Catalyst Institutions
- Identify and remove Impediments - investment environment
- Encourage “Best Practices”


# When to Intervene in an Institution?

- History of repeated failures to eliminate acceptance of status quo
- Prolonged “inspired” TA that has changed the corporate culture
- Educated, receptive local managers who want to demonstrate success
- Willingness of the government to cede control
- Legitimate market need not met by private sector competition
- The right management team

# Examples of “Catalyst” Intervention

-  Enterprise Funds - stimulate SME development & economic revival
-  History of repeated failures to eliminate acceptance of status quo
-  Prolonged “inspired” TA that has changed the corporate culture
-  ? Educated, receptive local managers who want to demonstrate success
-  Willingness of the government to cede control
-  Legitimate market need not met by private sector competition

# Examples of “Catalyst” Intervention

-  Cooperative Bank of Uganda - rebuild domestic cooking oil production
-  History of repeated failures to eliminate acceptance of status quo
-  Prolonged “inspired” TA that has changed the corporate culture
-  ? Educated, receptive local managers who want to demonstrate success
-  Willingness of the government to cede control
-  Legitimate market need not met by private sector competition



# Examples of “Catalyst” Intervention

## PRIDE Finance of Guinea - microfinance

 History of repeated failures to eliminate acceptance of status quo

 Prolonged “inspired” TA that has changed the corporate culture

? Educated, receptive local managers who want to demonstrate success

? Willingness of the government to cede control

? Legitimate market need not met by private sector competition

# Examples of “Catalyst” Intervention

 Agricultural Bank of Mongolia - rural banking

 History of repeated failures to eliminate acceptance of status quo

 Prolonged “inspired” TA that has changed the corporate culture

 Educated, receptive local managers who want to demonstrate success

 Willingness of the government to cede control

 Legitimate market need not met by private sector competition

# Intervening with a Specific Institution

- Risks
  - Performance risk - we look bad if it fails, and people could get hurt
  - Market risk - we may crowd out local initiatives, reducing competition
- Rewards
  - Economic growth - we act as catalyst and demonstration site
  - Good press - we are seen as a constructive force for change
- Risks must be manageable and potential rewards significant enough before we become involved in specific institutions

# Role of Foreign Banks in FS Development

## ➤ Follow existing clients

- ✓ Help existing clients to expand into new markets
- ✓ Enable the best local companies to reduce their funding cost
- ✓ Train banking staff who then migrate to local institutions

 Target prime borrowers, depriving local banks of sound lending

 Siphon off deposits, reducing lendable funds for local banks and increasing flight capital

- Twinning is a great idea, but ignores commercial realities



# Mortgage Banking

- Allows the owner of property to spread the acquisition cost over the “useful life” of the property, so lowers up front capital requirements
- Frees up capital from housing for investment in productive assets
- Expands funding available for housing
- Pre-requisites are:
  - Clear property rights legislation that is predictably enforced by the court system
  - Stable or rising property values and a trained network of appraisers
  - Sources of stable, long term funding for the lender
  - Reasonable market interest rates
  - Reliable property hazard insurance

# Defining Achievable Objectives

- Positive, permanent changes in behavior
- Quantifiable, sustainable results
- Harmonization with International Best Practices


# Targeting Performance

- Bad examples - focus on unrealistic results or actions that may not lead to a sustainable result
  - Good examples - focus on results
  - Focus on sustainable results, not actions
-  Achieve a CAMELS rating of no less than 3 for every bank
-  Each bank assigned a CAMELS rating calculated consistently according to reasonable and clearly defined criteria that conform to Basle Committee guidelines

# Targeting Performance

- Bad examples - focus on unrealistic results or actions that may not lead to a sustainable result
- Good examples - focus on results
- Focus on sustainable results, not actions

 Conduct 5 bank examinations


 Bank examination staff demonstrate ability to conduct a bank examination, identify areas for improvement, write report, review results with bank management, and achieve resolution of weaknesses



# Targeting Performance

- Bad examples - focus on unrealistic results or actions that may not lead to a sustainable result
- Good examples - focus on results
- Focus on sustainable results, not actions

 Revise banking laws

 Banking laws meet or exceed best practices as measured against best examples from comparable countries

# How can EGAT help?

- Provide access to experience in other countries
- Provide depth of expertise
- Assist with needs assessments and prioritization of tasks
- Provide link to IFI decision makers in DC on specific issues
- Simplify the contracting process

# Summary

- Banking development is a critical component of economic growth
- Careful project structure and collaboration with other donors more critical than in any other field
  - Successful projects can have a major positive impact
  - Inappropriate projects can do major damage

# Thank You

😊 We look forward to working with you.